It's all gone Pete Tong

TIM GOOD believes that HMRC and tax practitioners have been calculating top-slicing relief incorrectly. He suggests that it is time to follow the legislation rather than existing practice.

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In his article 'The heat is on' (*Taxation*, 10 September 2009, page 196) Richard Curtis questioned HMRC's application of the rules for top-slicing relief on non-qualifying policy gains. It seems that nothing came of Richard's valiant effort to correct an obvious error (*if I recall correctly this was 'a novel interpretation of the legislation' according to HMRC – Ed*). Well perhaps the time has come.

Not only do I agree with Richard's analysis, I have now codified (by way of an Excel spreadsheet) the correct application of the rules as he and I believe them to be. I have identified innumerable scenarios in which taxpayers with chargeable event gains are being overcharged – in some cases by tens of thousands of pounds. However, in other instances HMRC's calculation is too generous.

Unfortunately, it appears that all the commercial tax return software developers have either followed the HMRC calculation or prepared their own calculations, but using the same erroneous methodology.

A simple example

To illustrate the problem, let us suppose that a taxpayer had no income in 2016-17 other than employment income of £100,000 and a chargeable event gain of £100,000 on the encashment of a UK non-qualifying life policy held for two years (there can be no personal allowance even when calculating tax on one slice – let's keep it simple).

The HMRC system correctly calculates tax on the employment income as £33,600 (£32,000 at basic and £68,000 at higher rate) and then (correctly) calculates the tax liability on the chargeable event gain as in ***HMRC Computation 1***.

HMRC Computation 1

	Taxable £	*at* %	*Liability* £
Starting rate	0	0	0
Nil rate	0	0	0
Basic rate	0	0	0
Higher rate	50,000	40	20,000
Additional rate	50,000	45	22,500
Total chargeable event	100,000		
Tax on employment income as above			33,600
Income tax due			76,100

But what about the top-slicing relief? My reckoning is that the taxpayer can claim relief of £2,900, but the HMRC calculator only gives £2,500. How come?

The urban myth

Before we address the figures, an urban myth must be dispelled. This is that top-slicing relief is relevant only for higher and additional rate taxpayers and only where the full gain straddles

KEY POINTS

- Is tax being overcharged on non-qualifying life policies?
- Commercial software replicates HMRC's calculation method.
- Dispelling the myth that top-slicing relief is relevant only for higher and additional rate taxpayers.
- The three steps of calculating relieved liability under ITTOIA 2005, s 536.
- Worked examples comparing HMRC's approach and the legislation.
- Reopening assessments and recalculating liabilities?

the divide between rate bands. This is not the case. The relief is provided for in ITTOIA 2005, s 535 and nowhere does it refer to such taxpayers. Instead, it states: 'An individual is entitled to relief under this section for a tax year if:

(a) the individual's liability for the tax year, as calculated under subsection (3), exceeds
(b) the individual's relieved liability for the tax year, as calculated under:
    s 536 (top slicing relieved liability: one chargeable event); or
    s 537 (top slicing relieved liability: two or more chargeable events).'

So, instead of looking at marginal tax rates, we must perform the calculations specified in s 535.

The s 535 calculation

Section 535(3) states: 'An individual's liability for a tax year for the purposes of subsection (1)(a) equals TL – BRL, where:

- TL is the amount of the individual's total liability to income tax on income charged to tax under this chapter for the tax year, calculated on the basis that no relief is available under this section and the highest part assumptions apply; and
- BRL is the amount of income tax at the basic rate that the individual is treated as having paid under s 530(1) for the tax year.'

In my example TL is clearly £42,500 and BRL is £20,000 giving £22,500.

The s 535(1)(b) calculation

Having calculated the individual's liability under s 535(1)(a), we must now calculate their *relieved* liability under s 536, as instructed by s 535(1)(b). This has three steps:

- Step 1 identifies the annual equivalent or slice. In my example £100,000 divided by two years gives a slice of £50,000.
- Step 2 tells us to 'find the relieved liability on the annual equivalent by:
  (a) calculating the individual's liability (if any) to income tax on the annual equivalent, on the basis that:
      (i) the gain from the chargeable event is limited to the amount of the annual equivalent; and
      (ii) the highest part assumptions apply; and
  (b) subtracting the amount of income tax at the basic rate on the annual equivalent which the individual is treated as having paid under section 530(1).'
- Step 3 simply tells us to multiply the Step 2 figure by the number of slices.

For the purposes of my example, the highest part assumptions are inherent in the treatment of the chargeable event gain. This will be the top part of the total income in all the calculations.

However, they would be relevant if the taxpayer had dividends or other savings income (that bit was fun to codify).

So that leaves us to 'calculate the individual's liability (if any) to income tax on the annual equivalent, on the basis that the gain from the chargeable event is limited to the amount of the annual equivalent'. In my example, this calculation will compute the tax liability on the annual equivalent (slice) as shown in ***Top-slicing Relief***.

Top-slicing Relief

	Taxable £	at %	Liability £
Starting rate	0	0	0
Nil rate			
(personal savings allowance)	500	0	0
Higher rate	49,500	40	19,800
Less basic rate on:	50,000	20	10,000
Step 2 calculation			9,800
Relieved liability (Step 3)	£9,800		
	x 2 =		19,600

So the top-slicing relief must be as follows:

S 535(1)(a) liability	£22,500
Less: s 535(1)(b) relieved liability	£19,600
Top-slicing relief	£2,900

I cannot see any other way to apply the legislation. HMRC says the taxpayer must pay £53,600, but I maintain that the liability is £53,200. The observant reader will see that the difference of £400 is equivalent to the benefit of two personal savings allowances of £500 at 40%.

A rather different scenario

Suppose, instead, that a taxpayer has no income other than a chargeable event gain of £250,000 on the encashment of a UK non-qualifying life policy held for two years – let's keep it simple.

HMRC calculates the tax liability after top-slicing relief (TSR) as shown in ***HMRC Computation 2***.

HMRC Computation 2

	Taxable £	at %	Liability £
	5,000	0	0
	27,000	20	5,400
	118,000	40	47,200
	100,000	45	45,000
			97,600
Less: Top-slicing relief	11,400		
Notional tax at 20%	50,000		61,400
Tax due			36,200

Note that the above computation correctly applies the £5,000 savings rate band to the chargeable event gain. But how does the department arrive at the figure of £11,400? The answer is shown on page 16.

Tax on £250,000 (ignoring the savings rate band) is calculated as follows.

£	£	£
32,000 x 20%	6,400	
118,000 x 40%	47,200	
100,000 x 45%	45,000	
Total =		98,600
Tax on slice of £125,000:		
32,000 x 20%	6,400	
93,000 x 40%	37,200	
Total =	43,600	
Tax on two slices =		87,200
Top-slicing relief:		11,400

Again, this is wrong. In fact, the correct amount of top-slicing relief is £12,600 and the tax due is £35,000 rather than £36,200. The HMRC calculation adopts a simplified workaround that does not follow the legislation (see above). So taxpayers in such cases will have been overcharged – and they should now make amendments to any open 2015-16 returns as well as those for 2016-17.

Top Slicing 1 shows the correct calculation following the steps in ITTOIA 2005, s 535 and s 536:

Top Slicing 1

Section 535(1)(a) liability: £97,600 – £50,000 = £47,600
(This is the liability ignoring top-slicing relief less notional tax of £50,000)
Section 535(1)(b) relieved liability given by s 536:
Step 1 annual equivalent: £250,000/2 = £125,000
Step 2 relieved liability on annual equivalent:

Taxable £	*at* %	*Liability* £
5,000	0	
500	0	
26,500	20	5,300
93,000	40	37,200
125,000		42,500
Notional tax (£125,000 v 20%)		25,000
Relieved liability		17,500

Step 3	£17,500 x 2 =	£35,000
Excess of s 535(1)(a) over s 535 (1)(b) (£47,600 – £35,000):		£12,600

It is unarguable that the calculation of £12,600 is wrong because it follows the legislation to the letter. It is unhampered by any consideration of the allocation of any personal allowances or other reliefs or of any other income.

The HMRC calculation is wrong because it takes a shortcut that does not take account of the savings rate band or personal savings allowance. The difference of £1,200 can be explained because HMRC ignores the £5,000 savings rate band once in its calculation of tax on the full gain and then ignores it twice (two slices) in the calculation on the slice as well as ignoring the personal savings allowance that should be available if the income is just one slice. The net £1,200 is calculated as: ((£5,000 x (2 – 1)) + (£500 x 2)) x 20%.

The plot thickens

The waters become even murkier when the possibility of personal allowances is introduced.

Consider a taxpayer with employment income of £95,000 and a chargeable event gain of £100,000 on a UK policy held for ten years.

The HMRC test case generator shows this calculation.

Tax Calculation for 2016-17 (year ended 5 April 2017)

Income received (before tax taken off)			
Pay from all employments	£95,000		
Gains on life insurance policies etc	£100,000		
Total income received	£195,000		
Total income on which tax is due	£195,000		
How I have worked out your income tax			
Pay, pensions, profit etc (UK rate for England, Wales and Northern Ireland)			
Basic rate	£32.000	x 20%	£6,400
Higher rate	£63,000	x 40%	£25,200
Savings interest from banks or building societies, securities and gains on life policies			
Starting rate	£0	x 0%	£0
Nil rate	£0	x 0%	£0
Basic rate	£0	x 20%	£0
Higher rate	£55,000	x 40%	£22,000
Additional rate	£45,000	x 45%	£20,250
Total income on which tax has been charged	£195,000		
Income tax charged			£73,850
minus: top slicing relief			£2,250
minus: notional tax from gains on life policies etc			£20,000
Income tax due after allowances and reliefs			£51,600

My calculation of the net income tax liability after allowances and reliefs is £32,600 – a difference of £19,000. But how does this difference arise?

The top-slicing relief calculation

The HMRC top-slicing relief of £2,250 is calculated using its shortcut as follows.

Tax on chargeable event gain £100,000:

£	*at %*	£
55,000	40	22,000
£45,000	45	20,250
Total =		42,250
Tax on slice of £10,000		
£10,000 at 40%	£4,000	
Tax on ten slices (£4,000 x 10) =		40,000
Top-slicing relief:		£2,250

However, the correct calculation following the steps in ITTOIA 2005, s 535 and s 536 is shown in ***Top Slicing 2***.

Top Slicing 2

Section 535(1)(a) liability: £42,250 – £20,000 = £22,250

(This is the liability on the chargeable event gain ignoring top-slicing relief less the notional tax of £20,000)

Section 535(1)(b) relieved liability given by s 536:

Step 1 annual equivalent: £100,000/10 = £10,000

Step 2 relieved liability on annual equivalent:

Taxable £	*at* %	*Liability* £
8,500	0	0
500	0	0
1,000	40%	400
10,000		400
Notional tax at 20% x £1,500		300
Relieved liability		£100

Step 3	£100 x 10 =	£1,000
Excess of s 535(1)(a) over s 535(1)(b):		£21,250

The reason for the staggering difference in this example is that HMRC ignores the personal allowance which comes into play when only one slice of the chargeable event gain is brought into the calculation. For those readers who wish to delve further into this, the workings from my own calculator – which shows how (in my opinion) the s 535 calculation should be done properly – can be found with the website version of this article.

Counter-arguments

What counter-arguments could HMRC put to my interpretation and application of s 536? To reiterate, ITTOIA 2005, s 536(1) Step 2 says: 'Find the relieved liability on the annual equivalent by:

(a) calculating the individual's liability (if any) to income tax on the annual equivalent, on the basis that:
  (i) the gain from the chargeable event is limited to the amount of the annual equivalent; and
  (ii) the highest part assumptions apply; and
(b) subtracting the amount of income tax at the basic rate on the annual equivalent which the individual is treated as having paid under s 530(1).'

My proposition is that the only way to perform this calculation must be to carry out the ITA 2007 income tax calculation 'on the basis that the gain from the chargeable event is limited to the amount of the annual equivalent'.

Could an alternative interpretation be that the relieved liability is calculated by determining how much of the total tax liability ignoring top-slicing relief can be attributed to just one slice? In the ***Top Slicing 2*** example above, this would entail looking at the total tax calculation and determining that the first £10,000 of the chargeable event gain would be taxed at 40% so that tax on ten slices would be £40,000. This would indeed give top-slicing relief of only £2,500. But it is not what s 536(1) tells us to do.

The legislative draughtsman could just as easily have said something along the lines of: 'Calculate how much of the individual's liability to tax on income charged to tax under this chapter arises on the first annual equivalent amount of that income.' But he did not. If, in performing the s 536(1) calculation my way, the personal savings allowance and/or the personal allowance become available, the taxpayer should – in my opinion – benefit from this.

I would also add that the purpose of top-slicing relief is to put the taxpayer in the position they would have been if, in each year, they had received just one slice of the gain. My analysis accords with this purposive approach.

The bad news…

But what if the HMRC calculation is beneficial in some scenarios? Take a taxpayer with 2016-17 employment income of £18,000 and a chargeable event gain on a UK policy of £30,000 with a term of ten years.

The HMRC calculation gives top-slicing relief of £1,000 on the basis that the first £25,000 of the chargeable event gain is taxed at the basic rate (even though £500 of that is at 0%) and the top £5,000 at the higher rate, whereas one slice of £3,000 would be at the basic rate.

Using the 'shortcut method', this generates relief of £1,000 (£5,000 x (40% – 20%)). But my calculation would work out tax on one slice as £400 (£1,000 at 0% plus £2,000 at 20%) and on ten slices this makes £4,000, which is reduced to nil by the notional basic rate credit.

The s 535(3) calculation on the £30,000 is:

Taxable £	*at* %	*Liability* £
500	0	0
24,500	20	4,900
5,000	40	2,000
Total		6,900
Less: basic rate credit		6,000
Top-slicing relief		900

Thus, in scenarios such as this, the HMRC calculation benefits the taxpayer by £100 (incorrectly in my opinion).

Conclusion

So what should tax practitioners do in such cases now? My main recommendations are as follows.

First, do not rely on the HMRC calculation of top-slicing relief. Second, do not rely on your tax return software – almost all the main brands (my own included) clone the HMRC calculation. Third, review all clients who have had chargeable event gains in recent years and file amended returns if possible.

Finally, consider an appeal to the tribunal if HMRC refuses to accept that its calculation is wrong.

Tim Good is managing director of Absolute Accounting Software Ltd. He can be contacted by email at: tim.good@absolutetax.co.uk.